

No. 11,976

IN THE

United States Court of Appeals
For the Ninth Circuit

GRACE BROS., INC.,

Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S REPLY BRIEF.

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Subject Index

	Page
I. At least \$100,000 of the consideration received by petitioner for the assets of its winery business was received for the good will of the business and constituted capital gains	1
A. Introductory statement	1
B. The form of the transaction is not conclusive and should not prevail over the substance and effect	2
C. The testimony of Mr. Grace is entitled to full consideration and weight and the Tax Court erred in disregarding his testimony	4
D. In substance and effect the transaction was a sale of petitioner's entire winery business including its good will	7
II. Other issues	11
III. Conclusion	11

Table of Authorities Cited

	Pages
Betts v. United States, 62 Ct. Cls. 1	3
Didlake v. Roden Grocery So., 160 Ala. 484, 49 So. 384....	3
Helvering v. Tex-Penn Oil Co. (1937), 300 U. S. 481, 81 L. Ed. 755, 57 S. Ct. 569	3
Ida. P. Huggins, 1 T. C. 1214, Pren. Hall. T. C. Memo. Vol. 12, Par. 43172	9
Pfleggar Hardware Specialty Co. v. Blair, 2 Cir. (1929), 30 F. (2d) 614	3, 9
Watson v. Commissioner, 9 Cir. (1932), 62 F. (2d) 35....	3
Weiss v. Stearn (1924), 265 U. S. 242, 68 L. Ed. 1001, 44 S. Ct. 490	3
White & Wells, v. Commissioner, 19 BTA 416 affm'd, 2 Cir. 50 F. (2d) 120	3, 9

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I.

**AT LEAST \$100,000 OF THE CONSIDERATION RECEIVED BY
PETITIONER FOR THE ASSETS OF ITS WINERY BUSINESS
WAS RECEIVED FOR THE GOOD WILL OF THE BUSINESS
AND CONSTITUTED CAPITAL GAIN.**

A. Introductory statement.

Respondent's argument with regard to petitioner's contention that the transaction between petitioner and Garrett & Company, involved a transfer of the good will of petitioner's winery business is devoted primarily to a detailed discussion of the stipulated facts and evidence and his basic contentions appear to be (1) that in form the transaction was a sale of the wine inventory and a lease of the winery and equipment which did not involve petitioner's good will, and (2)

that the testimony of Mr. Grace is inconsistent with the form of the transaction and should be disregarded. Respondent completely disregards the substance and effect of the transaction and dismisses with brief comment the decisions which support petitioner's contention. Since petitioner has never denied that the transaction was in the form of a sale of wine, no attempt will be made in this brief to discuss the details stressed by respondent with regard to that point, and the argument will be confined to the basic issues and contentions.

B. The form of the transaction is not conclusive and should not prevail over the substance and effect.

In support of his contention that no part of the consideration received by petitioner was received by it for its good will, respondent emphasizes and relies primarily upon the fact that in the negotiations between the parties the written communications and agreements referred primarily to the wine inventory and made no mention of petitioner's good will. Petitioner has conceded from the outset that, in form, the transaction between it and Garrett & Company, was a sale of the wine inventory and a lease of the winery and equipment. Likewise petitioner has never contended that Garrett & Company sought to purchase or acquire the good will of petitioner's winery business. Petitioner's contention has been and now is that despite the form of the transaction, it did involve, in substance and effect, a transfer of petitioner's entire winery business including petitioner's good will. Petitioner has not challenged the facts as found by the

Tax Court but has based its appeal on the ground that the Tax Court erroneously interpreted the true nature of the transaction and based its decision entirely upon the form as set forth in the various written documents. Further discussion of the form of the transaction would be of no assistance in the determination of the real issue presented.

One of the basic principles of tax law is that taxation is a practical matter and that the determination of tax controversies should be based upon the substance and effect rather than the form of the transaction. This principle was established by early decisions of the Supreme Court of the United States and has been repeatedly announced by almost every Court. *Weiss v. Stearn* (1924), 265 U. S. 242, 68 L. Ed. 1001, 44 S. Ct. 490; *Helvering v. Tex-Penn. Oil Co.* (1937), 300 U. S. 481, 81 L. Ed. 755, 57 S. Ct. 569; *Watson v. Commissioner*, 9 Cir. (1932) 62 F.(2d) 35.

The decisions upon which petitioner relies and which petitioner contends decide the real issue involved in this case, establish that a transaction may involve a sale of the good will of a business even though the good will was not mentioned or specifically considered in the negotiations between the parties and the transaction was in form a mere sale of tangible assets. *White & Wells v. Commissioner*, 19 B.T.A. 416, Affm'd., 2 Cir. 50 F.(2d) 120; *Pfleggar Hardware Specialty Co. v. Blair*, 2 Cir. (1929), 30 F.(2d) 614; *Betts v. United States*, 62 Ct. Cls. 1; *Didlake v. Roden Grocery Co.*, 160 Ala. 484, 49 So. 384.

- C. The testimony of Mr. Grace is entitled to full consideration and weight and the Tax Court erred in disregarding his testimony.

Respondent challenges the testimony of Mr. Grace as being inconsistent with and contrary to the documentary evidence and suggests that little or no weight should be given to his testimony. Respondent's contentions in this regard are not well founded and are not justified by the facts and circumstances.

While it is true that Mr. Grace is an interested party, that is generally true in a tax case and certainly does not disqualify a witness. It should also be noted that Mr. Grace is a man of high standing in the community and has held high office in many business and civil organizations. (R. 20, 47-48.) Respondent's Exhibit M (R. 135) shows that Mr. Grace had made a full statement of the transaction to Government representatives before the trial of this case and that Mr. McFarland, the attorney who represented respondent at the trial had reviewed the statement with Mr. Weller, the representative of Garrett & Company. Mr. McFarland's conference with Mr. Weller apparently disclosed no important discrepancies in Mr. Grace's statement of the transaction for on cross-examination Mr. McFarland did not call attention to any discrepancies between Mr. Grace's testimony and his previous statement. These facts speak well for the accuracy and consistency of the testimony of Mr. Grace.

Despite the fact that the matter was not mentioned on cross-examination respondent now relies on his

Exhibit M (R. 135) in his effort to discredit the testimony of Mr. Grace. (Respondent's Brief, p. 16.) Respondent refers to Mr. Weller's statement that he did not recall that petitioner wanted to sell its plant to Garrett & Company and contends that that statement presents a material contradiction which would justify disregarding other portions of the testimony of Mr. Grace. Respondent omits to mention the preceding sentence in Mr. Weller's statement which reads as follows:

"They (Mr. McFarland and Mr. Tonjes) read me Mr. Grace's statement of the transaction *which was all right* with two exceptions and one was that Mr. Grace claims that when we were dickering he wanted to sell us the winery and made a price of \$125,000 on it but that we insisted that we would prefer a lease." (Italics supplied.) The other exception was that Mr. Weller put petitioner in touch with Taylor Company which purchased the plant in 1944.

Mr. Weller's voluntary statement that Mr. Grace's statement of the transaction, which presumably was the same as his testimony, "was all right" except for the two relatively unimportant exceptions mentioned, would seem to corroborate the testimony of Mr. Grace with regard to the principal elements of the transaction rather than contradict it as respondent contends.

Respondent stresses the fact that the testimony of Mr. Grace that he would not sell anything unless he sold the entire business including the good will is inconsistent with the documentary evidence in which

there is no mention of the good will. Mr. Grace explained that Mr. Weller suggested that he could give him the price asked by paying fifty cents a gallon for the wine. (R. 56.) Since the price was to be computed on the basis of the wine, there was no reason for making further mention of the good will. Respondent states that Mr. Grace could not explain how the good will value was computed in the prices set forth in his telegraphic communication to Garrett & Company in which he suggested varying prices for different wines. On redirect examination Mr. Grace explained that the prices quoted would have given petitioner a little more for its good will than he had asked originally and eventually received and that he thought Garrett & Company might pay the higher price because of the interest they had shown in the previous meetings. (R. 83.) In other words Mr. Grace was merely trying to secure a higher price than that at which he had offered to sell originally.

Respondent asserts that Mr. Grace exaggerated the value and importance of the winery personnel organization and to support this assertion respondent calls attention to Ex. 4-D (R. 121) from which respondent concludes that only \$10,700 was paid by petitioner in 1942 for all wages, salaries and commissions. On the basis of his interpretation of Ex. 4-D respondent asserts that there was "a deliberate effort to color the facts". (Respondent's Brief, p. 20.) While the record does not disclose the salaries which were paid to petitioner's key men and other regular employees, it appears, quite obviously, from an examination of

Ex. 4-D that salaries and other compensation paid in connection with the manufacture of wine were included as part of the Inventory Cost which was \$69,115.82 for the year 1942. There is no basis whatsoever in Ex. 4-D for respondent's conclusions or his accusations.

It is respectfully submitted that respondent's attempts to discredit the testimony of Mr. Grace are based entirely upon misinterpretations and distortions of the evidence. It is further respectfully submitted that the testimony of Mr. Grace is reasonable and logical and when considered in the light of his explanations is not inconsistent with the documentary evidence. Mr. Grace furnished respondent with a statement of the transaction *before* the trial, which was presumably the same as his testimony and that statement when investigated by respondent's attorneys was found to be correct in most material respects by Mr. Weller who represented Garrett & Company in the transaction. The testimony of Mr. Grace was uncontradicted, was in effect corroborated by Mr. Weller's letter (Ex. M, R. 135) and was entitled to full weight and consideration by the Tax Court.

D. In substance and effect the transaction was a sale of petitioner's entire winery business including its good will.

Both the Tax Court and respondent appear to have misunderstood or misinterpreted petitioner's contentions. Petitioner has never contended that it and Garrett & Company entered into an agreement for the sale and purchase of petitioner's good will as such.

Petitioner's contention is that the transaction was in substance and effect a transfer of petitioner's entire winery business and all the assets thereof and since the good will of a business is inseparable from the business, the good will was also transferred even though it was not specifically mentioned in the telegraphic negotiations or the final agreement and even though the purchaser may have had no particular desire for or interest in the good will.

Petitioner owned and operated a successful winery business which had good will of considerable value. Petitioner wanted to dispose of the business but was unwilling to do so except for a price which would be sufficient to compensate it for the tangible assets, which consisted primarily of its wine inventory, and the good will of the business. Petitioner so advised the prospective purchaser and was offered a price for its wine which equalled the total price it would have received for the wine if it had been sold in the regular course of its business plus the price it was asking for its good will.

In the transaction petitioner transferred, by sale and lease, all of the assets of its winery business. Petitioner's entire wine inventory, its plant and equipment, its labels, its list of customers, its staff of experienced employees and its permit to manufacture and sell wine all went over to Garrett & Company. Petitioner retained nothing except the reversionary interest in the plant and equipment which had been leased to Garrett & Company for five years with the

right of renewal. The good will of the business was inseparably attached to the assets which passed to Garrett & Company. Petitioner retained nothing to which the good will could attach. Good will cannot be separated from the business which creates it and it certainly did not remain with the reversionary interest in the plant and equipment.

In *White & Wells Co. v. Commissioner*, 19 B.T.A. 426, Affm'd. 2 Cir., 50 F.(2d) 120 and *Pfleggar Hardware Specialty Co. v. Blair*, 2 Cir., 30 F.(2d) 614, discussed in detail in petitioner's opening brief (pp. 22 to 26), on the basis of facts which were identical in all material respects the Circuit Court for the Second Circuit held that there was a sale of good will. Good will was not mentioned in the sales contracts in either of the cited cases. Likewise the facts establish that the purchasers had no need or desire for the good will of the sellers. In those cases, as here, the Commissioner contended that there had been no sale of good will. The Court held, however, that the good will passed with the other assets of the business and that part of the consideration received was for the good will.

The fact that the purchaser may not have wanted and may never have used the good will is not material. We are here concerned with the seller and its tax liability should be determined on the basis of the consideration it received for the assets it transferred. See *Ida P. Huggins*, 1 T. C. 1214, Pren. Hall, T. C. Memo. Vol. 12, Par. 43172

Perhaps the difficulty with the present case is that good will is an intangible asset which exists only in connection with the business to which it is attached. Suppose that a taxpayer owned and operated a store, with a valuable good will, at a location which was desired by another concern in an entirely different business. If the store owner required the purchaser to buy him out and pay a price which would compensate him for the entire business including the good will, the fact that the purchaser did not want the good will and never made use of it should not have any bearing upon the determination of whether the seller sold his good will or whether part of the consideration received was for the good will.

In the present case petitioner had valuable good will for which it expected to and insisted that it receive compensation. It received the full amount it demanded but in the form of a payment for wine. The fact that the contract recited that the payment was for wine should not change the fact that as far as petitioner was concerned part of the consideration which it received was for its good will.

The evidence establishes that petitioner valued its good will at \$100,000 and included that amount as its price for the good will in determining the total price which was finally received. The record also establishes that the total consideration exceeded the average price at which the wine was being sold in the regular course of business by approximately \$100,000. (R. 60.)

Petitioner respectfully submits that its winery business had a good will value of approximately \$100,000, that in the transfer of all the assets of said business to Garrett & Company, part of the consideration received was allocable to the good will and that the Tax Court erred in failing and refusing to so find.

II.

OTHER ISSUES.

The authorities and arguments with regard to the other issues presented in this appeal are fully presented in petitioner's opening brief (pp. 39 to 46) and no further discussion appears to be necessary.

III.

CONCLUSION.

Petitioner respectfully submits:

(1) That the evidence and authorities cited and discussed in the briefs clearly establish that in the transaction between petitioner and Garrett & Company, petitioner sold its entire winery business including its good will and that at least \$100,000 of the consideration received by petitioner was received by it for its good will.

(2) That since the transaction was a sale of its entire winery business the entire gain constituted long term capital gain and not ordinary income.

(3) That prior to the sale the wine inventory was converted into a capital asset and the gain realized from the sale of the wine (except 4,959 gallons) was long term capital gain and not ordinary income.

Petitioner further respectfully submits that the determination of the Tax Court that the transaction between petitioner and Garrett & Company was merely a sale of wine and barrels and a lease of the winery and that the entire gain constituted ordinary income is clearly erroneous and should be reversed.

Dated, San Francisco, California,
December 15, 1948.

Respectfully submitted,
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